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Deregulation of the foreign exchange market and reserve requirement policy

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Before the announcement of the new corridor a broad discussion was mostly concentrated only around one aspect of future exchange rate policy. Namely, it contemplated whether there should be the floating regime or a new corridor. It did not, however, relate to main objectives of monetary policy. The ultimate objective of any monetary authority is to stabilize the price level, and thus a value of domestic currency.

At this moment policy targets have already been set mainly in the recently adopted budget law. It is based on assumptions about inflation of 19 percent (December-to-December), the monetary base increase of about 10 percent (originally 17.6 percent) and the average exchange rate of 4 UAH/USD for 1999. The corridor was set at the value of 3.4 – 4.6 UAH/USD. Altogether, it implies a considerable “dose” of devaluation (25- 35 percent) next year.

Apart from the quantitative targets, the exchange rate policy has to deal with the problem of existing administrative controls in the foreign exchange market. Liberalization of the market ought to be perceived as an additional objective of the policy. Additionally, it is one of preconditions for disbursement of next tranches of the EFF program. It implies that a framework of monetary and fiscal policies will have to cover a strategy of foreign exchange market deregulation.

This paper focuses on the only one aspect of monetary policy in the context of foreign exchange market deregulation. It discusses the current situation of the banking system and points out necessary monetary policy conditions for successful deregulation of the foreign exchange market. With scarcity of instruments and their ineffectiveness reserve requirements become an extremely important part of monetary policy. This paper considers reserve requirements as the most potent instrument of NBU monetary policy at this moment. Last six months indicate, however, that this instrument was not appropriately used, thus its policy has to be significantly improved. Otherwise deregulation of the foreign exchange market and achievement of the intended goals of macroeconomic policy would not be possible.

Reduction of liquidity in the banking system

From the point of view of stability in the entire monetary system the very first moment of the foreign exchange market liberalization is extremely important. The monetary authority has to deal with liberalization of the foreign exchange market in a way that would not create excessive devaluatory pressure threatening achievement of the intended inflation target. At this moment certain stability conditions have to be in place otherwise the pressure can arise.

First of all, liquidity of the banking system has to be reduced in order to keep a balance between the domestic money supply and the foreign exchange supply in the system. Commercial banks and economic agents will not speculate against UAH if the domestic currency remains expensive. Therefore, it is crucial to eliminate pressure on UAH by withdrawing potential speculative overhang from the banking system. It implies that the stance of the banking system, especially in its commercial banks component, has to be carefully followed. Instruments of monetary policy will work properly only if accurate prudential regulations are fulfilled.

At the same time other channels of liquidity injection have to be blocked. As a very short-term measure the government should control its spending in order not to provide additional financial resources to the market at the moment of liberalization. While in the longer perspective it should stick to the targets in the budget law preventing itself from expending the deficit. The above implies that the NBU should not increase domestic credit if it wants to successfully deregulate the foreign exchange market.

Policy of reserve requirements

Balancing the foreign exchange market can only be achieved by reduction of the domestic money supply since the NBU does not hold sufficient amount of foreign reserves to intervene in the market. As a result, the central bank has to focus its restrictive monetary policy on instruments, which are potent to reduce the money supply.

The NBU can influence monetary conditions through its impact on the reserve money. The reserve requirement is one of the main instruments available. The others are: rediscount policy, financing of the budget deficit, foreign exchange interventions and certificates of deposit which have been issued since Feb. 5, 1999.

Effectiveness of all monetary policy instruments has been significantly reduced since August 1998. As a result of applied administrative measures and increasing uncertainty in the financial sector, the interbank money market considerably shrank. Restructuring of public debt to commercial banks put some of them into a difficult financial situation as well. This, in turn, drastically squeezed transmission channels of monetary policy. Poorly functioning interbank market does not reallocate free financial resources among banks, which do not hold enough liquidity. As a result, liquidity in the banking system can be disproportionately allocated in different banks and there is no effective mechanism of liquidity equating. It implies that the monetary policy is significantly limited in terms of potential instruments and their effectiveness. In that respect reserve requirements instrument of monetary policy becomes an important tool of liquidity management since it can directly control individual banks' liquidity.

Let's examine the efficiency of reserve requirement (rr) instrument of monetary policy.

Main changes:

- 1) In Nov. 1997 commercial banks were permitted to use T-bills (purchased after mid-Nov. and held to maturity) to meet the rr. Additionally in Dec. 1997 the rr ratio was raised from 11% to 15%. These actions were the result of tightening the monetary policy followed by the Asian crisis and outflow of portfolio capital from Ukrainian market.
- 2) As the result of Russian crisis and destabilization at financial markets in Ukraine in Sep. 1998 the NBU raised the reservation norm from 15% to 16.5% of sums attracted by banks. Moreover the NBU canceled the clause permitting banks to include their cash and OVDP holdings in their mandatory reserves. The NBU has also introduced a daily monitoring of banks' rr.
- 3) On Nov. 1, the NBU began monitoring the rr every ten day.
- 4) On Jan. 1, the NBU discontinued the practice of calculating the value of bank's blocked bonds as part of their mandatory reserves. Meanwhile, the NBU has not unblocked the OVDPs and converted bonds previously calculated as part of mandatory reserves. The rr ratio was decreased to 15%.
- 5) On Feb. 10 the NBU has raised the mandatory rr rates from 15% to 17%, effective in third part of Feb.

Execution:

Banks often argue that they can not fulfill the rr because they have liquidity problems as the result of OVDPs conversion. According to official information in the first tranche of commercial banks' OVDP portfolio restructurization, 8 banks accepted proposed conditions, in

the second tranche 24 banks agreed to convert the governmental obligation before them. In Sep. 1998 about 80 banks had liquidity problems. The main reasons behind such poor performance were withdrawal of deposits from the banking sector, contraction of the interbank credit market, increase in rr ratio, stricter reservation procedures, and the suspension of active banking operations. From Nov. about 30 banks permanently do not meet mandatory rr (table 1). It could be assumed that the problem banks are those which converted government bills. If it would be the truth the NBU should officially announce the existence of special criteria concerning banks that converted OVDP instead tolerating non-accomplishment.

Table 1. How many banks failed to meet rr?

Sep. 1998	80 (Association of Ukrainian Banks: 50 out of them failed to meet rr due to OVDPs conversion)
Nov. 1998	30 (short of reserves by UAH 260 mn)
Jan. 1, 1999	over 30 (or 12% of banks), short of the target by UAH 445 mn
Jan. 22	UAH 124 mn short of rr

Source: Ukrainian News Agency and Interfax Ukraine

From September 1998 to February 1999 the amount of funds kept on correspondent accounts with the NBU has tripled. One could say it was the result of increase rr, but in January the ratio decreased and the amount of money on correspondent accounts did not stop growing. It could be the result of increasing deposits in commercial banks, limited possibilities of investment at hryvna secondary market and foreign currency market. In Nov. 1998 the banking sector excess reserves (voluntary over the required reserves, see:chart) turn to be positive, and at the same time short of the target reserves in the whole banking sector was by UAH 260 mn. It means that if the NBU was able to make banks perform rr, the problem of overliquidity would not exist.

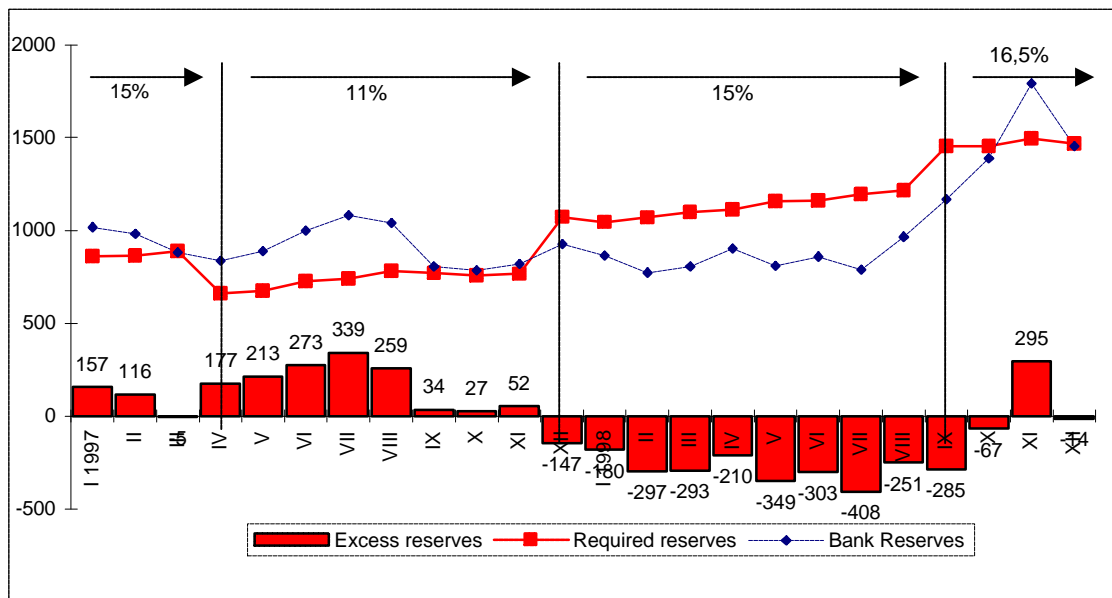
Table 2. Remainder of Funds Correspondent Accounts with the NBU (UAH mn)

Aug. 31	700
Sep. 1	562.9 (out of this 40 mn is overliquidity)
Sep. 4	646.3
Sep. 11	746.5
Sep. 17	762.4
Sep. 25	849.6
Nov.	1300
Jan. 1999	1295
Feb.	1532

Source: Ukrainian News Agency and Interfax Ukraine

What is interesting about the rr policy is the behavior of excess reserves beginning Sep. 1998. Since that time banks have been officially banned to include T-bills and cash in rr. One could expect problems with liquidity at banks and negative reserves. Meanwhile, in Nov. there was an excess of reserves in the whole banking system. It means that although some banks permanently do not fulfill the rr ratio, the other have some additional liquidity, which can be directed to the foreign exchange market if it would be liberalized.

Chart. Reserve requirement performance.



Source: NBU Bulletin, authors' calculations.

Concluding remarks

The commercial banks would put a pressure on hryvna unless the economy starts working. T-bills market will not revoke for next few months. There will be no good investment projects in non-growing economy. If the central bank wants to create favorable conditions for economic growth it should introduce the market-based mechanisms in the currency market. To do this without creating additional devaluationary pressure it must enforce effective instruments of liquidity management. One of them is rr, which must be properly enforced to be effective.

In the situation when banks have limited possibilities of short-term liquidity management, overliquidity will be a persistent problem in such an over-regulated environment. Therefore, an increase in rr should be used to reduce liquidity and support liberalization of the currency market.

One could expect that if the central bank would be able to make banks perform rr, the overliquidity on correspondent accounts (the most liquid forms of bank assets) would decrease. Increasing the rr ratio to curb the liquidity and on the other hand tolerating non-accomplishment of reserve criteria of about 30 banks, means that such a policy punish the best banks.

If banks non-performing rr are these which converted OVDP it should be officially announced that they are treated differently (maybe another rr ratio should be adopted). If non-performing banks are these, which did not convert OVDP, the NBU should impose penalties, including liquidation of banks. Regulations (i.e. imposed fines) without enforcement undermine credibility of the NBU. Differentiation of rr ratio would be much better policy choice then arbitrary, non-transparent treatment criteria and privileges.

The rr is not an instrument of short-term liquidity management. If rules change every month, banks can not properly manage their assets and this policy could even cause additional liquidity problems. RR could not be the only one instrument of liquidity management in the banking sector. The NBU has to develop open market operations, which is much better instrument of short-term liquidity management. Certificates of deposits should play this role.

Appendix

Administrative regulations on the currency market - last changes.

- 1) The NBU decided **Nov.23** to allow resident commercial banks to extend hard currency loans for production needs to companies.
- 2) The NBU board issued a telegram Jan.11 allowing commercial banks with foreign capital participation from **Jan. 15** not to convert into hryvnia contributions to their statutory funds made in hard currency and placed with the NBU. According to the telegram currency contributions to ownership funds of commercial banks with foreign capital will not be added to their open currency position if they are placed in a special account at the NBU. Previously, banks were prohibited to hold statutory funds in foreign currencies.
- 3) The NBU norms for banks' currency position were to come into force from **Jan. 15**. Under the new rules, the total open currency position must not exceed 35% of the bank's own capital. At the same time the bank's long position in hard currency must not exceed 30% and short position 5%. An open currency position in non-convertible currency must not exceed 3% and in bank metals 2%. From Aug. 22 to Dec. 29, the NBU forbade commercial banks to have an open currency position altogether. Before Aug. 22, the admissible level was 30%. After Dec. 29 - 20%.
- 4) On **Jan. 5** the NBU lowered the maximum foreign currency yield on government foreign loan bonds from 21,5% to 20%. The rate is subject to monthly revisions by the NBU. The rate had been unchanged since September 1998.
- 5) The NBU issued a telegram banning banks belonging to the Ukrainian and Crimean Interbank Currency Exchanges from buying or selling currency on the exchange by order of other banks from **Feb. 1**. In addition, the NBU decision allows only Crimea-registered banks or the Crimean branches of banks from other regions to trade on the Crimean Interbank Currency Exchange.

The IMF continuously insisted on lifting restrictions on access to the foreign currency. According to NBU Chairman Viktor Yuschenko speaking at the press conference on January 19, the deregulation policy will include about 10 or 12 consecutive steps. He said the central bank would first remove restrictions on cash deals of the foreign exchange market (margins). Yuschenko said that the pace of deregulation would depend on government's budget discipline and situation on the stock market.